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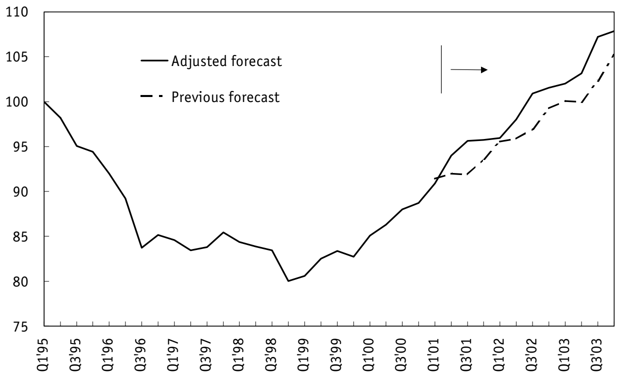
Domestic demand is the engine of growth

A new issue of ICPS's Quarterly Predictions journal will be published this week. We forecast that GDP growth in Ukraine in 2001–2003 will be primarily driven by increasing domestic demand. We have adjusted upwards our forecast for GDP growth in 2001, to 8%. However, the unbalanced quality of the government's economic policy and the lack of skilled labour or productive investments will hold back rapid economic growth. We forecast that GDP growth in Ukraine will decelerate to 5% in 2002; in 2003, growth will pick up slightly, to 6%, following the implementation of the tax reform

Figure Real GDP

Index [Q1'95=100], seasonally adjusted



Source: State Statistics Committee; forecast by Quarterly Predictions.

In Q2'01, GDP growth accelerated again. Over January-June, GDP increased by 9.1% y-o-y. The growth leaders were the manufacturing industries and trade sector, largely because of a boost in domestic demand-meaning primarily private consumption, which increased by 12.1% y-o-y in H1'01. Among the main contributors to the accelerated growth in trade (13.5% y-o-y in H1'01) were the simplified taxation system adopted for small enterprises and increased productivity.

We anticipate that output will stabilise in H2'01, but taking into consideration the high growth pace in H1'01, we reconsidered our forecast for 2001 and ended up increasing it. GDP will grow by 8% in 2001.

On the one hand, gradually recovering private farms (following the 2000 reforms) have sparked a productivity rise in the agricultural sector; therefore, farmers can promptly respond to increased domestic demand. Also, higher attractiveness of the sector (in terms of bank lending) has helped farmers to obtain short-term loans for the purchase of fuels, seeds, fertilisers, and spare parts. As a result, we expect that the value-added in the sector will grow by 6.5% in 2001 overall (4.8% y-o-y in H1'01).

On the other hand, exports grew significantly over H1'01, on the back of a larger than expected drop in imports. In H2'01, however, we expect that the tendency will switch, with export growth decelerating while import growth picks up. In our opinion, Ukrainian producers will curb exports due to worsened conditions in external markets, while real appreciation of the hryvnia will promote imports.

Labour productivity has been increasing in trade and industry but declining in health care

Productivity growth is a major determinant of the Ukrainian economy's robust growth. To test our hypothesis regarding productivity growth, we calculated labour productivity, which is the most widely used measure of productivity.

Our calculations revealed that labour productivity rose at the highest rate in trade and industry during 1996–2000. Increased productivity allowed producers to react promptly to the increased domestic demand for consumer and investment goods. Higher productivity implies raising output at the least cost, thus providing for more flexible pricing strategies, investments in broadening the product range, and hiring more skilled workers.

Meanwhile, labour productivity in education has increased very slowly, while in health care it has even fallen. This creates a serious threat to the quality of human capital in the future and a long-term improvement of the Ukrainian households' welfare. In our opinion, the reason for low productivity in these sectors is inefficient allocation of resources, inherited from the Soviet times. This inefficiency is revealed by the following:

- *The number of teachers per pupil and doctors per 1,000 residents is far in Ukraine than corresponding indicators in other countries.*
- *High fixed costs of running the infrastructure put in place during Soviet times (e.g., electricity bills, current and capital repairs).*
- *Narrow specialisation of employees in these sectors. In developed countries, a schoolteacher usually runs several courses. A Ukrainian teacher usually specialises in one area. As a result, the number of teachers remains unchanged while the number of pupils diminishes.*

In our opinion, there is enormous potential for increasing productivity in education and health care. How fast this gap is filled will determine the quality and long-term robustness of economic growth in Ukraine. In the nearest years, the most important factor that would raise productivity in education and health care will be the systematic (programmatic) planning of budget expenditures.

Gradual worsening of Ukraine's economic policy poses a threat to further economic growth.

The approaching parliamentary elections lessen the possibility of maintaining a balanced budget in H1'02, which may easily result in price increases and a higher exchange rate. Due to worsened expectations of economic agents in response to political instability and the likely fragility of financial indicators, we forecast that economic growth will decelerate to 5% in 2002.

We expect that tax reform will be implemented in Ukraine beginning in 2003, thus prompting GDP growth to accelerate by 6% that year.

Factors of growth

In our opinion, rapid GDP growth will be maintained over the forecast period, largely because of increased domestic demand. According to our forecast, the contribution of domestic demand to GDP growth will be greater than of external demand. This tendency is completely opposite to the tendency of 1999-2000, when exports made the biggest contribution to GDP growth.

In our opinion, the following determinants will lead to growth in domestic demand:

- Higher consumer confidence. According to the consumer survey conducted by ICPS and GfK-USM, the consumer confidence index increased by 3.7 percentage points in H1'01, primarily due to buoyed expectations for economic development over the next year and 5 years.
- Increased real household incomes, thanks to rising wages and decelerating inflation. Another factor that will amplify household incomes will be a cut of the personal income tax rate in 2003.
- Boosting investment demand in the business sector. The lack of productive capital will force firms to rapidly replace obsolete equipment. As a result, volumes of loans extended by banks should grow.

Rapid growth of domestic demand will push through further structural changes in the industrial sector. We anticipate that the weights of the food and machine-building industries in the industrial output will grow. Meanwhile, contributions of the ferrous metals and metal products industries will gradually decline over 2001–2003.

The structure of exports will follow a similar pattern. Rapidly growing food and machine-building industries will increase the sales of their products to foreign customers.

What are the constraints to growth?

We believe that a more efficient allocation of available resources was important in promoting GDP growth since mid-1999. In particular, competition forced entrepreneurs cut their costs by releasing surplus labour. Thanks to the releases, labour productivity increased in the industrial and trade sectors.

This strategy, however, has been losing its value, since the increasing demand prompts firms to employ more labour and capital of a higher quality. Trying to expand their activities, entrepreneurs are likely to face the following challenges:

- The lack of skilled labour. The still unreformed educational system cannot satisfy the demand of enterprises for a modern labour force.
- The lack of quality capital. A tiny share of the net capital investments in GDP indicates that installed capacities have been rapidly wearing out but are being slowly displaced by new equipment. ■

Major indicators

	2000	2001 (estimate)	2002 (forecast)	2003 (forecast)
Economic activity				
GDP, millions UAH	172,952	210,329	244,575	282,207
Real GDP, apc*	5.8	8.0	5.0	6.0
Real industrial production, apc	12.9	15.0	8.0	8.5
Real agricultural output, apc	7.6	7.0	5.5	5.0
Gross investment, % GDP	18.6	19.0	19.4	20.3
FDI, millions USD (1)	594	650	1,400	1,500
Real household disposable incomes, apc	11.1	9.0	7.0	8.0
Real retail trade, apc	7.5	7.5	6.0	6.5
Prices				
Consumer price index, apc	26	12	11	7
Producer price index, apc	21	7	9	8
Labour market				
Population, millions	49.3	49.1	48.9	48.7
Real wage, average apc	1.0	9.0	3.0	6.0
Official unemployment rate, %	4.2	4.5	5.0	5.5
Foreign economic activity				
Exports of goods&services, apc	20.3	6.0	5.5	6.0
Imports of goods&services, apc	18.9	8.0	8.0	7.5
Current account balance, % GDP	4.7	3.0	2.0	1.0
Budget				
Revenues (consolidated), % GDP	28.4	27.0	27.0	25.0
Current balance, % GDP	0.4	0.3	0.5	0.2
Balance by IMF methodology, % GDP	-1.1	-1.0	-2.3	-1.0
Monetary indicators				
Monetary base, apc	39	25	18	14
M3, apc	45	31	20	16
NBU international reserves, millions USD	1,539	1,970	2,570	3,040
Official exchange rate average annual, UAH/USD	5.44	5.42	5.65	5.83
Interest rate on loans, average annual, yearly % (2)	41	32	28	25
International				
World GDP, apc	4.7	2.6	3.3	3.6
GDP of Ukraine's major trading partners (2/3 of exports), apc	6.0	2.9	4.0	4.0

** apc = annual percentage change*

Notes:

(1) according to NBU

(2) commercial banks loans, hryvnias

Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.

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